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Inflation dynamics and monetary policy transmission in Vietnam and emerging Asia

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ABSTRACT

This paper provides an overview of inflation developments in Vietnam in the years following the *doi moi* reforms, and uses empirical analysis to answer two key questions: (i) what are the key drivers of inflation in Vietnam, and what role does monetary policy play? and (ii) why has inflation in Vietnam been persistently higher than in most other emerging market economies in the region? It focuses on understanding the monetary policy transmission mechanism in Vietnam, and in understanding the extent to which monetary policy can explain why inflation in Vietnam has been higher than in other Asian emerging markets over the past decade.

1. Introduction

Vietnam has been in transition from a centrally planned to a 'socialist oriented market economy' since the introduction of the *doi moi* economic reforms in 1986. In the early-to-mid 1990s, liberalization measures resulted in rapidly expanding exports and high economic growth, with real GDP growth averaging 9 percent per year. Growth slowed in the late 1990s but the momentum picked up again, with real GDP growth rising more-or-less steadily and reaching a high of 8.5 percent in 2007. Since then, growth has slowed down, reaching 5.0 percent in 2012, largely as a result of tighter monetary and fiscal policies and spillovers from the global economic crisis (World Bank, 2012). At the same time inflation fell sharply through the course of 2012, with CPI inflation falling from 18.1 percent at end-2011 to 6.8 percent at end-2012, and core inflation falling from 14.3 percent to 9.6 percent over the same period.

Despite the deceleration in inflation, Vietnam has suffered from higher and more volatile inflation compared to most emerging Asian economies since mid-2007 (Fig. 1). This in turn is a reflection of weaknesses in the macroeconomic policy framework. In particular, monetary policy in Vietnam has been criticized for lack of transparency and predictability, and for following multiple – and at times conflicting – objectives (International Monetary Fund, 2010; Moody's Investor Services, 2011). In practice, four key objectives have been guiding monetary policy in Vietnam in the recent past, namely promoting

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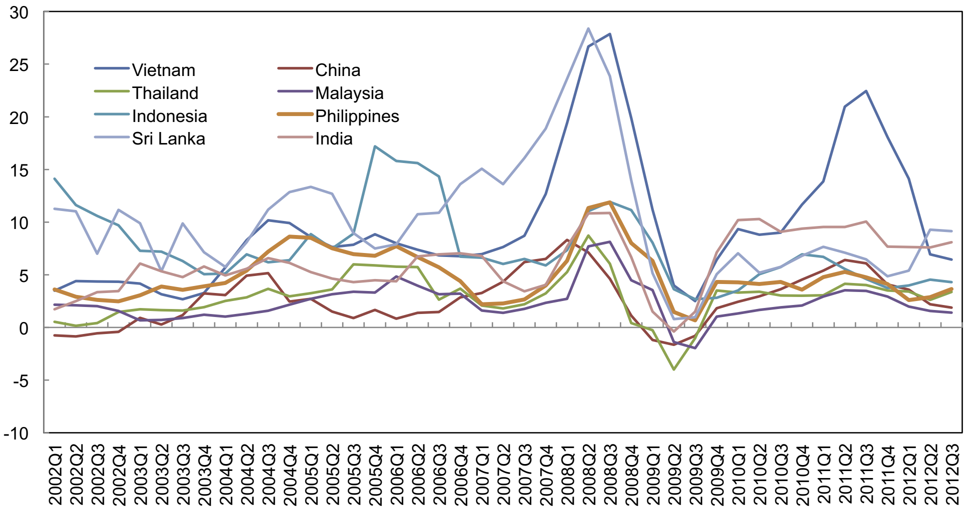

Fig. 1. Emerging Asia: headline inflation [1/] (in percent; year-on-year).
Source: CEIC Data Company Ltd. 1/ Calculated as the year over year percentage change on seasonally adjusted data.

economic growth, fighting inflation, stabilizing the exchange rate, and preserving the stability of the financial system. There is also prevalent use of caps on interest rates and controls on credit.

Although the monetary policy framework in Vietnam has been criticized by various (internal and external) observers, empirical work to see how the monetary policy transmission mechanism operates in practice and affects inflation has been relatively limited to date. Moreover, it has at times provided conflicting results and policy conclusions. This paper aims to make a contribution in this area.

Section 2 provides an overview of inflation developments in Vietnam in the years following the *doi moi* reforms. This is followed by a brief review of the existing empirical literature on inflation in Vietnam in Section 3. Section 4 presents a very simple theoretical model of inflation, and Section 5 presents and discusses the empirical results obtained from an econometric analysis of the data. The empirical analysis seeks to answer two key questions: (i) what are the key drivers of inflation in Vietnam, and what role does monetary policy play? and (ii) why has inflation in Vietnam been persistently higher than in most other emerging market economies in the region? The final section presents the conclusions and discusses the policy implications of the empirical analysis presented in this paper.

2. Inflation developments

Vietnam experienced a bout of hyperinflation in the second half of the 1980s and early 1990s, but a major stabilization effort brought inflation under control. Tight monetary and fiscal policy played a key role in bringing inflation down from annual rates greater than 300 percent in 1986–1988 to less than 20 percent in 1992 and to close to 10 percent in 1995 (Camen, 2006). Stabilization efforts led to a strong growth performance in the early 1990s (International Monetary Fund, 2010; Maliszewski, 2010).

Inflation remained subdued while growth slowed down in the late 1990s and early 2000s. While the Asian crisis was the principal cause of the slowdown in growth in the late 1990s, it was also partly due to the increasingly unsustainable composition of growth in the past which was heavily dependent on capital-intensive investment, mainly by state-owned enterprises in uncompetitive sectors. The economy began to rebound in late 1999 – largely due to a revival of domestic investment – but it was growing at a slower rate than in the early 1990s. Vietnam experienced two years of mild deflation in 2000 and 2001 owing to excess capacity and depressed commodity prices, and both the headline and core inflation rates remained low in 2002 and 2003 (Maliszewski, 2010).

Inflation rose sharply as growth picked up strongly between 2004 and mid-2008, reflecting sustained increases in international commodity prices and growing excess demand, due in large part to heavy investment by state-owned enterprises and a surge in foreign direct investment in the run-up to Vietnam's accession to the World Trade Organization (International Monetary Fund, 2010). Headline inflation reached a peak of almost 25 percent in the third quarter of 2008 but then started to decline sharply as a result of weakening domestic demand and lower food and energy prices, falling to 2.4 percent by the third quarter of 2009.

However, headline inflation then started to pick up again toward the end of 2009, reflecting in part the impact of the economic stimulus package introduced in response to the global crisis. A sizeable fiscal policy stimulus amounting to around 5 percent of GDP was executed in 2009, while the base (prime) rate was cut by a total of 700 basis points between October 2008 and February 2009 and kept at 7 percent until November 2009. Meanwhile, liquidity was injected through open market